

## Message Text

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PASS TREASURY, LABOR AND FRB

E.O. 11652: N/A

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SUBJECT: A MACROECONOMIC ASSESSMENT OF THE GOVERNMENT'S  
ATTACK ON INFLATION

REF: (A) LONDON 10678, (B) LONDON 11291, (C) LONDON  
11251, (D) 11645

SUMMARY: THE SUCCESS OR FAILURE OF THE LABOR GOVERNMENT  
PROGRAM TO REDUCE WAGE AND PRICE INCREASES TO 10 PERCENT  
BY NEXT SEPTEMBER WILL ULTIMATELY DEPEND ON THE ATTITUDE  
AND FOREBEARANCE OF THE MORE POWERFUL TRADE UNIONS TO  
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DECLINES IN REAL INCOME. UNLIKE THE HEATH GOVERNMENT'S

WAGE AND PRICE CONTROL MEASURES IN 1972, LABOR'S PROGRAM IS BEING INTRODUCED IN A PERIOD OF RISING UNEMPLOYMENT AND DECLINING PRODUCTION. THIS, COUPLED WITH THE POLITICAL ALTERNATIVE -- THE UNIONS IN THE LAST ANALYSIS WOULD BE RELUCTANT TO DEFEAT A MAJOR LABOR GOVERNMENT PROGRAM AND THEREBY RISK A RETURN TO CONSERVATIVE GOVERNMENT -- GIVE THE PROGRAM A BETTER CHANCE OF A LESS HOSTILE AND MILITANT UNION REACTION. MOREOVER, SOUNDINGS BY SOME KEY UNIONS OF THEIR GRASSROOTS MEMBERSHIP HAS INDICATED A MORE SOBER REALIZATION BY THE RANK AND FILE ABOUT THE SERIOUSNESS OF THE ECONOMIC CRISIS FACING THE UK. EVEN IF THE PERMITTABLE LEVEL OF WAGE INCREASES IS RESPECTED, THE RATE OF CONSUMER PRICE INCREASES WILL NOT BEGIN TO FALL BELOW THE 16-18 PERCENT LEVEL UNTIL THE SECOND QUARTER OF 1976, AT WHICH TIME THERE WILL BE WAGE NEGOTIATIONS WITH THE TRADE UNIONS EXPECTED TO SUFFER MOST FROM THE EFFECTS OF THE PROGRAM. THIS WILL BE THE CRUCIAL TESTING PERIOD FOR THE PROGRAM. IF THE SAVINGS RATE DECLINES TO MORE NORMAL LEVELS AND WORLD TRADE AND UK EXPORTS INCREASE, THEN THE LEVEL OF DOMESTIC ECONOMIC ACTIVITY SHOULD NOT SUFFER TOO GREATLY. IF THESE DEVELOPMENTS DO NOT COME ABOUT, THE SECOND HALF OF 1975 WILL SEE A MORE SEVERE ECONOMIC DOWNTURN, TO A DEGREE NOT EXPECTED BY THE GOVERNMENT; THIS WOULD BRING INCREASING POLITICAL PRESSURE FOR REFLATIONARY DOMESTIC POLICIES. MOST OBSERVERS. BUT NOT ALL, CONSIDER THAT THE PROGRAM ESTABLISHES THE PRECONDITIONS FOR AN UNDERLYING IMPROVEMENT IN THE ECONOMY. THERE ARE GENUINE GROUNDS FOR HOPE, BUT BASED ON PAST PERFORMANCE, NO PARTICULAR GROUNDS FOR OBJECTIVE OPTIMISM UNTIL THE ACTUAL RESPONSE IS RECEIVED FROM THE UNIONS, WHICH WILL MAKE OR BREAK THE PROGRAM.

END SUMMARY

#### BACKGROUND AND INTRODUCTION

1. ON JULY 1 THE PRIME MINISTER ANNOUNCED A NEW PROGRAM CALLED THE "ATTACK ON INFLATION". IT AIMS AT BRINGING CONSUMER PRICES DOWN TO NO MORE THAN A 10 PERCENT ANNUAL RATE OF INCREASE BY THE LATE SUMMER OF 1976 AND A FURTHER REDUCTION BY THE END OF NEXT YEAR TO SINGLE FIGURES.

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THE GOVERNMENT PROPOSES TO ACHIEVE THIS AIM THROUGH A PAY INCREASE LIMIT OF 6 POUNDS (ABOUT \$13.20) PER WEEK WITH NO INCREASE AT ALL FOR THOSE EARNING ABOVE 8,500 POUNDS (ABOUT \$18,700) A YEAR. EMPLOYERS WOULD FACE PENALTIES FOR NON COMPLIANCE; WORKERS WOULD NOT. THE GOVERNMENT IS PREPARING STANDBY LEGISLATIVE POWERS TO PROVIDE FOR ENFORCEMENT; THESE HAVENOT YET BEEN MADE PUBLIC; THE GOVERNMENT HOPES IT WILL NOT BE NECESSARY TO INTRODUCE

THEM. THE PROGRAM ALSO MAKES PROVISION FOR CASH LIMITS ON PUBLIC EXPENDITURE AND AN ORDERLY REDUCTION OF THE PUBLIC SECTOR BORROWING REQUIREMENT. THE TECHNICAL DETAILS OF THE PROGRAM, AMENDMENTS TO THE PRICE CODE, THE PARLIAMENTARY DEBATES AND INITIAL UNION REACTION ARE SPELLED OUT IN THE REFERENCED CABLES. THIS MESSAGE ASSESSES THE MAIN POINTS OF THE GOVERNMENT'S PROGRAM, INCLUDING ITS LIKELY ECONOMIC AND POLITICAL IMPACT AND POTENTIAL FOR SUCCESS.

2. THE CURRENT BRITISH INFLATIONARY CYCLE DID NOT START WITH THE LABOR GOVERNMENT, ALTHOUGH THE NOXIOUS TRENDS

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HAVE BEEN EXACERBATED SINCE LABOR TOOK POWER. THE UK HAS BEEN HIT BY A SERIES OF INTERNAL AND EXTERNAL SHOCKS SINCE 1971-72 THAT HAVE PROGRESSIVELY INCREASED PRICES AND WAGES. FACED WITH A DOMESTIC SLUMP IN 1970-71, THE CONSERVATIVE GOVERNMENT REFLATED THROUGH CONSUMER-LED GROWTH AND DOMESTIC BUDGET DEFICITS. TO DEAL WITH PRICE AND WAGE INCREASES, THE CONSERVATIVE GOVERNMENT IN NOVEMBER 1972 IMPOSED WAGE AND PRICE CONTROLS, WHICH INCLUDED ESCALATOR CLAUSES ALLOWING WORKERS TO NEGOTIATE FOR WAGE INCREASES OF ROUGHLY UP TO ONE PERCENT WHENEVER THE CONSUMER PRICE INDEX INCREASED BY THAT AMOUNT.

3. SINCE THEN, THE UK ECONOMY, LIKE OTHERS, HAS BEEN LIMITED OFFICIAL USE

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BUFFETED BY THE OIL-PRICE INCREASES; IN ADDITION, IT HAS SUFFERED FROM SEVERE INDUSTRIAL UNREST IN THE WINTER AND SPRING OF 1973-74 AND WAGE INCREASES WHICH OVER THE PAST SIX MONTHS HAVE BEEN RUNNING AT ANNUAL RATES OF INCREASE OF ROUGHLY 30 PERCENT. CURRENT TRENDS HAVE BEEN MADE WORSE BY THE LABOR GOVERNMENT'S UNWILLINGNESS OR INABILITY, UNTIL NOW, TO ACCEPT A CONFRONTATION WITH THE UNIONS, WITHOUT WHOSE SUPPORT THEY FEAR THEY WOULD BE

UNABLE TO GOVERN. THE SIZE OF THE GOVERNMENT'S OWN

BORROWING REQUIREMENTS AND DEFICITS HAS ALSO PROGRESSIVELY INCREASED, AS BAD INITIAL ESTIMATES HAVE BEEN TRANSFORMED INTO EVEN WORSE ACTUAL RESULTS, RESULTING IN A GOVERNMENT BORROWING REQUIREMENT OF ROUGHLY 9 PERCENT OF GNP. THIS IN ITS TURN MAY ADD ADDITIONAL INFLATIONARY PRESSURE TO THE SYSTEM DURING COMING MONTHS.

4. THE LABOR GOVERNMENT TOOK POWER FOLLOWING THE MINERS' STRIKE AND THE THREE-DAY WEEK. FORMER PRIME MINISTER HEATH FOUGHT THE ELECTION ON THE QUESTION OF WHO RULES BRITAIN. THE ELECTORATE FAILED TO PROVIDE A CLEAR ANSWER AND SINCE FEBRUARY 1974, THE LABOR GOVERNMENT HAS BEEN VERY CAREFUL NOT TO TAKE ON THE TRADE UNIONS IN ANY CONFRONTATION THAT WOULD HAVE RISKED A MAJOR BATTLE. BY AGREEING TO THE MINERS' DEMANDS, THE LABOR GOVERNMENT OPENED THE DOOR TO ANNUAL WAGE SETTLEMENTS ON THE ORDER OF 30 PERCENT. THE SOCIAL CONTRACT DID NOT SUBSTANTIALLY REDUCE THE LEVEL OF THESE SETTLEMENTS BECAUSE SOME KEY UNIONS, WHILE AGREEING THAT ORGANIZED LABOR SHOULD BE

BOUND BY ITS TERMS, CLAIMED THAT THEIR PARTICULAR CIRCUMSTANCES JUSTIFIED EXCEPTIONAL TREATMENT. MOREOVER, THE LANGUAGE OF THE SOCIAL CONTRACT WAS VAGUE ENOUGH THAT IT WAS SUBJECT TO DIFFERING INTERPRETATION.

5. AS A RESULT, DURING 1974 AND THUS FAR IN 1975,

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MASSIVE WAGE INCREASES HAVE ADDED FURTHER WOES TO AN ECONOMY ALREADY BESET BY A LONG LIST OF STRUCTURAL WEAKNESSES. BY ABOUT APRIL OF THIS YEAR, INFLATION WAS ACCELERATING TO AN ANNUAL RATE OF OVER 20 PERCENT AND A

CRISIS OF CONFIDENCE BEGAN TO DEVELOPWH STELL # DE-

PRECIATED RAPIDLY AND BY AUG3 IT WAS OBVIOUS THAT SOMETHING DRASTIC HAD TO BE DONE. THE WHITE PAPER POLICY REPRESENTS THE GOVERNMENT'S ATTEMPT TO CHANGE THE PREVAILING CLIMATE.

6. THE GOVERNMENT'S POLICY OUTLINED IN ITS WHITE PAPER ENTITLED "THE ATTACK ON INFLATION" AT LEAST GIVES CAUSE TO BELIEVE THAT FOR THE FIRST TIME SINCE IT ASSUMED POWER, THE LABOR PARTY IS TURNING ITS FULL ATTENTION TO THE DOMESTIC ECONOMIC PROBLEMS THAT PLAGUE THE COUNTRY. IN FAIRNESS, DIFFERENCES WITHIN THE LABOR PARTY AND THE BITTERNESS OF THE BATTLE LEADING UP TO THE EC REFERENDUM CONSUMED AN INORDINATE AMOUNT OF MINISTERIAL TIME AND EFFORT THAT CAN NOW BE DIRECTED TO OTHER MATTERS.

7. RECALL THAT THE UK HAS BEEN LAGGING IN THE INTERNATIONAL BUSINESS CYCLE. DURING THE FIRST HALF OF 1975 BOTH INFLATION AND UNEMPLOYMENT RATES INCREASED, INVESTMENT IN MANUFACTURING DECLINED, PROFITS REMAINED LOW AND BUSINESS CONFIDENCE WEAK. THE POUND DECLINED STEADILY BOTH AGAINST THE DOLLAR AND ON A TRADE WEIGHTED BASIS, WITH RECURRENT PRESS REPORTS OF A POSSIBLE RUN ON STERLING, ESPECIALLY IF FOREIGN DEPOSITORS WERE TO WITHDRAW THEIR FUNDS. THE CHANCELLOR, BOTH IN HIS APRIL BUDGET SPEECH AND IN DISCUSSING THE NEW PROGRAM, HAS STRESSED THE NECESSITY OF REASSURING FOREIGN INVESTORS IN ORDER TO MAINTAIN THEIR CONFIDENCE.

8. A ROUGH APPRECIATION OF THE EVOLVING ECONOMIC PICTURE CAN BE GOTTEN FROM THE FOLLOWING TABLE WHICH SHOWS DEVELOPMENTS OVER THE PAST THREE YEARS:

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PERCENT CHANGE

(MAY TO MAY UNLESS OTHERWISE INDICATED)

1973/72 1974/73 1975/74

WHOLESALE PRICES

INPUT (1) 24.9 61.7 5.2

|                           |      |      |      |
|---------------------------|------|------|------|
| OUTPUT (2)                | 5.8  | 24.1 | 25.7 |
| CONSUMER PRICES           | 9.5  | 16.1 | 25.1 |
| AVERAGE EARNINGS (3)      | 14.4 | 13.5 | 27.1 |
| WAGES (3)                 | 15.2 | 16.4 | 32.6 |
| INDUSTRIAL PRODUCTION (4) | 6.9  | 0.3  | -8.2 |

#### RATES AT END OF PERIOD

JUNE 1973 JUNE 1974 JUNE 1975

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#### UNEMPLOYMENT

|                           |      |      |      |
|---------------------------|------|------|------|
| PERCENT                   | 2.7  | 2.4  | 3.7  |
| EXCHANGE RATE             | 2.58 | 2.39 | 2.19 |
| (POUNDS/DOLLARS)          |      |      |      |
| STERLING TRADE-WEIGHTED   | 14.1 | 17.0 | 28.9 |
| DEVALUATION (SINCE 12/71) |      |      |      |

- (1) PRICE CHANGES OF BASIC MATERIALS AND FUELS PURCHASED BY MANUFACTURING INDUSTRY.
- (2) PRICE CHANGES OF THE OUTPUT FOR DOMESTIC SALES OF BROAD SECTORS OF INDUSTRY
- (3) ALL INDUSTRIES
- (4) MANUFACTURING INDUSTRIES

9. THE NEW PROGRAM IS DESIGNED TO STOP THE DETERIORATION SHOWN IN THE ABOVE TABLE AND TO BRING BRITISH PRICES BACK TO AN INTERNATIONALLY COMPETITIVE LEVEL. THE GOVERNMENT WAS FORCED TO ACT, IN VERY LARGE PART BECAUSE OF INDICATIONS THAT FOREIGN INVESTOR CONFIDENCE HAD ABOUT REACHED ITS LIMITS.

10. THE CHANCELLOR'S BASIC ECONOMIC STRATEGY IS UNCHANGED; THE UK MUST LOOK FOR ITS FUTURE GROWTH THROUGH AN EXPANSION OF EXPORTS AND INVESTMENT WHICH IN TURN WILL BRING ABOUT THE EXTRA DEMAND NEEDED TO REDUCE UNEMPLOYMENT; THIS WILL REQUIRE A CONTINUING SHIFT IN THE BALANCE OF RESOURCES AWAY FROM CONSUMPTION. HIS STATEMENT TO THE HOUSE OF COMMONS ON JULY 21ST GAVE EXPLICIT RECOGNITION THAT THE LEVEL OF WAGE SETTLEMENTS HAD GOTTEN OUT OF HAND AND MUST BE REDUCED. THE CHANCELLOR STRESSED THAT THERE IS NO WAY OF BRINGING DOWN THE RATE OF INFLATION AS FAST AS NEEDED EXCEPT BY ACTING DIRECTLY ON LEVELS OF WAGE SETTLEMENTS.

#### THE TACTICS AND ASSUMPTIONS UNDERLYING THE PROGRAM

11. THE CENTRAL OBJECTIVE OF THE WHITE PAPER IS A 60 PERCENT REDUCTION IN THE RATE OF INFLATION WITHIN 15 MONTHS. THE GOVERNMENT'S GOAL IS TO BREAK THE VICIOUS CIRCLE OF MASSIVE WAGE INCREASES WHICH HAVE BEEN FOLLOWED

BY LARGE PRICE INCREASES, COUPLED WITH DECLINING DEMAND,  
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LOWER LEVELS OF INVESTMENT, HIGHER UNEMPLOYMENT AND A WEAKENING POUND. THE MAIN POINT OF ATTACK IS THE RATE OF WAGE INCREASE. IN THE PRESENT SITUATION OF RAPIDLY INCREASING UNEMPLOYMENT THE GOVERNMENT IS BETTING THAT A SHARP REDUCTION IN REAL DISPOSABLE INCOMES (4-6 PERCENT ACCORDING TO SOURCES OF THE NATIONAL INSTITUTE FOR ECONOMIC AND SOCIAL RESEARCH, ABOUT HALF OF WHICH IS DIRECTLY ATTRIBUTED TO THE WAGE CEILING) WILL BE GENERALLY ACCEPTABLE TO THE UNIONS FOR A LIMITED AND CLEARLY DEFINED TIME PERIOD. THEN, AS THE POLICY TAKES HOLD, IT IS EXPECTED THAT INDUSTRY WILL EXPERIENCE A RECOVERY IN PRODUCTION LEVELS AND PROFITS DURING THE FIRST AND SECOND HALF OF 1976, WITH REAL GDP GROWTH ABOVE 3 PERCENT OCCURRING IN THE SECOND HALF OF 1976 OVER THE SAME PERIOD IN 1975. THE EXPECTED INCREASE IN PROFITS APPEARS TO BE BASED ON 3 ASSUMPTIONS; FIRST, THAT, AS RATE OF GROWTH OF WAGE INCREASES FALLS, DOMESTIC DEMAND WILL REMAIN FLAT OR FALL ONLY SLIGHTLY PROVIDED CONSUMERS REDUCE ABNORMALLY HIGH SAVINGS LEVELS TO SUPPLEMENT LOWER LEVELS OF REAL INCOME; SECOND, THAT THERE WILL BE A REDUCTION IN "FISCAL DRAG" SINCE SMALLER WAGE INCREASES ARE LESS AFFECTED BY HIGHER MARGINAL TAXATION; AND THIRD, THAT DEMAND, BOTH IN THE U.S. AND IN THE CONTINENTAL COUNTRIES, FOR BRITISH EXPORTS WILL INCREASE AS ECONOMIC UPTURNS IN THOSE COUNTRIES GATHER MOMENTUM. THE INCREASED PRODUCTION AND PROFITS THUS

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GENERATED WOULD IN TURN STIMULATE INVESTMENT AND REDUCE  
UNEMPLOYMENT IN THE SECOND HALF OF 1976. AS A RESULT  
BY THIS TIME NEXT YEAR, BRITAIN WOULD BE IN THE ROAD

TO ECONOMIC RECOVERY.

12. THE MECHANICS FOR IMPLEMENTING THE ANTI-INFLATION  
PACKAGE HAVE BEEN SPELLED OUT IN THE REFERENCE CABLES.  
THE KEY ECONOMIC VARIABLES WHOSE BEHAVIOR WILL CONTRIBUTE  
TO THE SUCCESS OR FAILURE OF THE PROGRAM ARE (A) THE  
ATTITUDE AND FOREBEARANCE OF THE MORE POWERFUL TRADE  
UNIONS IN THE FACE OF DECLINES IN REAL INCOME, (B) THE  
LEVEL AND BEHAVIOR OF CONSUMER SAVINGS, (C) DEMAND FOR  
UK EXPORTS, (D) HOLDING THE LINE ON GOVERNMENT BORROWING  
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REQUIREMENT AND PUBLIC SECTOR EXPENDITURE LEVELS IN CASH  
TERMS, AND (E) EVENTUAL IMPROVEMENT IN CORPORATE PROFITS  
AND RETURN ON INVESTMENT.

13. ASSUMING THAT THE 6 POUND LIMIT IS RESPECTED, THAT  
THE LEVEL OF CONSUMER SAVINGS AS A PERCENTAGE OF DIS-  
POSABLE PERSONAL INCOME FALLS FROM ITS PRESENT PEAK OF  
12 TO 13 PERCENT TO A MORE NORMAL RATE OF 8 TO 10  
PERCENT, THAT DEMAND FOR UK EXPORTS RISES SIGNIFICANTLY,  
THAT CORPORATE PROFITS REBOUND AS INTENDED, THAT THE  
GOVERNMENT IS ABLE TO MAINTAIN ITS FY-1975/76 BORROWING  
REQUIREMENT AT THE PRESENT 9 BILLION POUND LEVEL, AND  
THAT THERE ARE NO UNEXPECTED EXTERNAL SHOCKS, THE CON-

SENSUS OF ECONOMIC OPINION, INSIDE AND OUTSIDE OF GOVERNMENT, IS THAT THERE IS A REASONABLE PROSPECT OF THE RATE OF PRICE INCREASES BEING REDUCED TO THE NEIGHBORHOOD OF 10 PERCENT BY SEPTEMBER 1976, WITHOUT BRINGING ABOUT A SERIOUSLY ADVERSE IMPACT ON THE ECONOMY DURING THE NEXT TWELVE MONTHS.

14. THE DECELERATION IN THE RATE OF INFLATION IS NOT EXPECTED TO BE SMOOTH. PRICE INCREASES ALREADY IN THE PIPELINE VIRTUALLY ENSURE THAT INFLATION WILL CONTINUE AT OR NEAR PRESENT LEVELS (26 PERCENT) THROUGH THE FOURTH QUARTER OF THIS YEAR. THE FIRST EFFECT OF THE SIX POUND CEILING SHOULD BE MANIFESTED IN A GRADUAL SLOWING OF THE RATE OF INCREASE DURING THE FIRST QUARTER OF 1976, TO THE 17 TO 20 PERCENT RANGE BY MARCH. THIS WOULD BE FOLLOWED BY A MUCH SHARPER DECLINE DURING THE SECOND AND THIRD QUARTERS UNTIL THE 10 PERCENT TARGET IS REACHED AROUND SEPTEMBER.

15. IN LAUNCHING ITS ATTACK ON INFLATION, THE WILSON GOVERNMENT ENJOYS SEVERAL ADVANTAGES NOT AVAILABLE TO THE HEATH GOVERNMENT IN 1972 WHEN IT ATTEMPTED TO CONTROL WAGES AND PRICES. FIRST, WHERE HEATH TRIED TO IMPOSE CONTROLS DURING AN UPTURN, THE ECONOMY TODAY HAS ENTERED A PERIOD OF RECESSION WHERE DEMAND IN FACTOR MARKETS IS WEAK AND UNEMPLOYMENT IS RISING. SECOND, WHERE THE UNIONS WERE ABLE TO DEFEAT THE 1972 CONTROLS, THE PRESENT UNION LEADERSHIP APPEARS TO ACCEPT A DEGREE OF LIMITED OFFICIAL USE

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RESPONSIBILITY FOR THE SHORTCOMINGS OF THE SOCIAL CONTRACT, HAS BEEN LECTURED REPEATEDLY ABOUT THE DIRE CONSEQUENCES FOR THE STANDARD OF LIVING OF UNION MEMBERS IF FOREIGNERS LOSE CONFIDENCE IN STERLING AND THE GOVERNMENT'S ABILITY TO CONTROL THE ECONOMY, AND HAS THEREFORE BEEN MORE RESPONSIVE TO GOVERNMENT PRESSURES TO ACCEPT THE CURRENT PROGRAM. THIRD, AND PROBABLY MOST IMPORTANT, THERE HAS BEEN A PALPABLE SHIFT IN PUBLIC OPINION TOWARD A WILLINGNESS, AT LEAST IN THE SHORT RUN, TO MAKE THE SACRIFICES NEEDED FOR THE SUCCESS OF THE PROGRAM. THE POLITICAL OPPOSITION FROM THE EXTREME POLITICAL LEFT IS SEEN AS MANAGEABLE.

THE UNCERTAIN OUTLOOK

16. GIVEN THE NUMBER AND THE NATURE OF THE ASSUMPTIONS NECESSARY FOR SUCCESS, THE PROGRAM IS VULNERABLE. ASSUMING A 2 TO 1 VOTE OF APPROVAL BY THE TUC CONFERENCE IN SEPTEMBER, THE FIRST REAL TEST OF THE WHITE PAPER WILL OCCUR IN OCTOBER WHEN ABOUT ONE MILLION LOCAL

AUTHORITY MANUAL WORKERS ARE DUE TO RENEGOTIATE THEIR CONTRACT. SINCE THIS GROUP RECEIVES LESS THAN THE NATIONAL AVERAGE WAGE OF ROUGHLY 55-57 POUNDS PER WEEK, A SIX POUND INCREASE MEANS MORE THAN A 10 PERCENT RISE IN PAY. HENCE IT SHOULD NOT BE DIFFICULT TO MAINTAIN THE SIX POUND LIMIT WITH THIS GROUP, THOUGH A FULL SIX POUND SETTLEMENT WOULD NOT BE FULLY IN ACCORD WITH REDUCTION OF THE RATE OF INFLATION TO 10 PERCENT. HOWEVER, THE CRUCIAL TEST WILL COME DURING THE FIRST AND SECOND QUARTERS OF 1976 WHEN NEGOTIATIONS WITH THE

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MINERS AND OTHER BELL-WEATHER UNIONS ARE SCHEDULED. IF THE 6 POUND LIMIT HOLDS IN THESE NEGOTIATIONS, THE

PROGRAM SHOULD SUCCEED. THE ECONOMIC FACTORS INFLUENCING THE UNIONS' ATTITUDE TOWARD THE OUTCOME OF THESE NEGOTIATIONS WILL INCLUDE THE RATE OF INCREASE IN PRICES (LIKELY TO BE DECLINING GRADUALLY, BUT STILL IN THE 17 TO 20 PERCENT RANGE) AND THE LEVEL OF UNEMPLOYMENT (SUBSTANTIALLY MORE THAN THE PRESENT 1.1 MILLION) WHICH COULD BE A MODERATING FACTOR.

17. OTHER SIGNS OF THE PROGRAM HAVING THE DESIRED IMPACT WILL INCLUDE IMPROVEMENT IN CORPORATE PROFITS TRENDS AND RETURN ON INVESTMENT. THERE SHOULD ALSO BE AN IMPROVEMENT IN THE UNDERLYING STRUCTURE OF CURRENT LIMITED OFFICIAL USE

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ACCOUNT IF EXPORTS BECOME MORE COMPETITIVE AND DEMAND INCREASES OVERSEAS. THERE WILL, HOWEVER, BE A CYCLICAL OFFSET AS IMPORTS INCREASE TO REBUILD INVENTORIES.

18. IF SAVINGS LEVEL DO NOT RESPOND, OR IF EXPORTS DO NOT PICK UP AND THE GROWTH OF WORLD TRADE REMAINS SLUGGISH LONGER THAN EXPECTED, THE DECLINE IN ECONOMIC ACTIVITY (AND EMPLOYMENT AND INVESTMENT) LATER THIS YEAR AND IN THE EARLY MONTHS OF 1976 WILL BE MORE SEVERE, ENGENDERING IN TURN HARSHER UNION AND LEFTWING LABOR PARTY CRITICISM OF THE PROGRAM. THIS WOULD CERTAINLY INCLUDE CALLS FOR INCREASED PUBLIC EXPENDITURE AND DEFICIT FINANCING WHICH IN TIME COULD BECOME POLITICALLY DIFFICULT FOR THE LABOR PARTY LEADERSHIP TO RESIST. EQUALLY, SHOULD A MAJOR UNION, SUCH AS THE MINERS, DELIBERATELY SEEK TO BREACH THE WAGE LIMIT BY A LARGE AND NOTICEABLE AMOUNT, THE GOVERNMENT WOULD BE PLACED IN THE UNENVIABLE POSITION OF HAVING TO TAKE ON THE UNION IN A BATTLE IT MIGHT NOT WIN OR SEEING ITS ANTI-INFLATION PROGRAM CRUMBLE. BEFORE ALLOWING THINGS TO COME TO SUCH A PASS, HOWEVER, THIS GOVERNMENT WILL CONDUCT ITS DIPLOMACY WITH THE TRADE UNIONS WITH MAXIMUM FLEXIBILITY AND SEEK TO GENERATE PRESSURES FOR COMPLIANCE ON POTENTIAL ROGUE UNIONS FROM WITHIN THE LEADERSHIP OF ORGANIZED LABOR ITSELF.

19. WHILE RECENT UK ECONOMIC HISTORY AND PERFORMANCE PROVIDE NO GROUND FOR OPTIMISM, WE ARE PREPARED TO ACCEPT THE JUDGMENT OF SOURCES AT THE TREASURY, CBI AND NIESR, THAT THE GOVERNMENT PROGRAM HAS PROVIDED THE ATMOSPHERIC CHANGE WHICH IS A PRECONDITION FOR REAL ECONOMIC IMPROVEMENT. LEAVING ASIDE ANY EXTERNAL SHOCKS TO THE ECONOMY, IT WILL BE THE RESPONSE OF THE UNIONS IN THE NEXT TWELVE MONTHS IN THE FACE OF DECLINING REAL INCOME THAT WILL MAKE OR BREAK THE PROGRAM, AND WE REALLY WON'T KNOW UNTIL SPRING, 1976. THE GOVERNMENT

WILL STILL FACE TRICKY DECISIONS BOTH MANAGING THE  
PROGRAM AND WHEN IT ENDS NEXT SEPTEMBER. THERE WILL BE  
A PHASE TWO; MINISTERS ARE ACUTELY AWARE OF THIS; IT IS  
LIKELY TO BE BASED ON PERCENTAGE WAGE INCREASES RATHER  
THAN ON A LUMP SUM TO PARTIALLY RESTORE WAGE DIFFEREN-  
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TIALS THAT WILL HAVE BEEN ERODED BY THE PRESENT POLICY.  
IF THE GOALS OF THE PROGRAM HAVE BEEN ACHIEVED, ANY  
DISTORTIONS ARISING FROM THE RIGIDITIES IMPOSED WOULD  
BE HANDLED IN A MUCH HEALTHIER ECONOMIC ATMOSPHERE.

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## Message Attributes

**Automatic Decaptioning:** X  
**Capture Date:** 01 JAN 1994  
**Channel Indicators:** n/a  
**Current Classification:** UNCLASSIFIED  
**Concepts:** UNION GOVERNMENT RELATIONS, POLICIES, ANTIINFLATIONARY PROGRAMS, PRICE CONTROLS  
**Control Number:** n/a  
**Copy:** SINGLE  
**Draft Date:** 01 AUG 1975  
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**Disposition Approved on Date:**  
**Disposition Authority:** RowellE0  
**Disposition Case Number:** n/a  
**Disposition Comment:** 25 YEAR REVIEW  
**Disposition Date:** 28 MAY 2004  
**Disposition Event:**  
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